Supreme Court of the United States

OCTOBER TERM 1945

No. 223

IN THE MATTER

OF

1934 REALTY CORP.,

Debtor.

PRUDENCE REALIZATION CORPORATION,

Petitioner,

THE HURD COMMITTEE, the petitioning creditors, and CARROLL DUNHAM 3RD and EDWARD K. DUNHAM as Trustees of the Estate of David Dows,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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Counsel for Prudence Realization Corporation, Petitioner.

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To the Honorable the Chief Justice of the Supreme Court of the United States of America and the Honorable Associate Justices thereof:

Your petitioner, Prudence Realization Corporation, respectfully submits this, its petition for a writ of certiorari to review the decision and order of the United States Circuit Court of Appeals reversing the order of the District Court entered in a reorganization proceeding under Chapter X of the National Bankruptcy Act. The order denied a motion to amend a previously confirmed plan of reorgani-

zation so as to reserve the status of the claim of Prudence Realization Corporation for subsequent determination by "a court of competent jurisdiction", on the basis of "the rights existing immediately prior to the filing of the petition (for reorganization) herein". The Circuit Court of Appeals reversed the order and directed subordination of the claim of Prudence Realization Corporation.

Opinions Below

No written opinion was rendered by the District Court on his decision on this question.* A written opinion was rendered by the Circuit Court of Appeals (R. 156, not yet reported).

Jurisdiction

The decree of the Circuit Court of Appeals was entered on June 22, 1945 (R. 159). The issuance of the mandate pursuant to such decree has been stayed by the Circuit Court of Appeals. The jurisdiction of this Court is invoked under Section 240a of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. Sec. 347-a).

Questions Presented

The Circuit Court of Appeals held that after the status of petitioner's claim in a Chapter X reorganization had

* Four appeals involving the status of petitioner's claim were taken by respondents. The appeal from the order confirming the plan was dismissed by the Circuit Court of Appeals (R. 159), the one here involved was reversed (R. 159), and the appeals from the order of consummation and the order denying respondents' motion to reconsider and reject petitioner's claim were considered moot in view of the disposition here (R. 159). The opinion of the District Court illustrating his reasoning appears in this record at page 139.

been adjudicated, and no appeal had been taken from the allowance of the claim, and a plan based upon such allowance had been confirmed, the District Court erroneously rejected specific proposed amendments which provided for the reservation of the question of the status of the claim for subsequent determination by a court of competent jurisdiction on the basis of rights as they existed prior to the institution of the reorganization proceeding. The Court recognized the invalidity of the proposed amendments, but asserted jurisdiction to reverse the District Court's rejection upon the general prayer for relief contained in the motion proposing such amendments. The Court held the concurring opinion of Chief Justice Stone in *Prudence Realization Corporation* v. *Ferris*, 65 Sup. Ct. 539, at page 542, controlling on the question of petitioner's participation, and without independent examination held that petitioner's certificates were subordinate to other certificates of participation in the mortgage on the property of this debtor.

The questions presented are:

1. In a reorganization proceeding under Chapter X of the Bankruptcy Act, is the statutory rule of pro rata distribution to be abandoned where the insolvent guarantor of all of the claims asserted in the proceeding was guilty of inequitable conduct?

2. Is the rule of subordination of the claim in bankruptcy of a solvent surety in competition with its insured applicable where the guarantor has become insolvent and the claim for subordination is asserted against all of its creditors in order to secure preference in the distribution of its estate?

3. In a Chapter X reorganization, is the allowance of a claim subject to collateral attack after the time to appeal has expired?

4. Under Chapter X, after a plan has been finally confirmed and improper specific amendments are proposed and properly rejected by the court, does the appellate court have jurisdiction under a general prayer for relief to grant relief which is inconsistent with the theory of the petition offering the amendments without affording the respondent on the motion an opportunity, by proof, to meet the issues originated by the court?

Statement

The Prudence Company, Inc., hereafter called "Prudence", was organized under the Banking Law of the State of New York in 1919. It was engaged in the business of making loans secured by mortgages on real estate. The bonds and mortgages received for such loans were assigned to an affiliated corporation, Prudence-Bonds Corporation. In many instances, Prudence-Bonds Corporation transferred these bonds and mortgages to corporate trust companies called depositaries and issued certificates of participation in such mortgages to Prudence which in turn sold them to the general public together with its guaranty of payment of principal and interest. The guaranty of Prudence called for the payment of interest on the certificates when due and for the payment of principal upon collection but in no event later than eighteen months after maturity and payment shall have been demanded in writing (R. 25).

These mortgage participation certificates constituted the holders thereof tenants in common of the underlying mortgage and bond secured thereby (*In re Westover* (C. C. A. 2d), 82 F. (2d) 177).

As part of its business, from time to time Prudence either repurchased some of these certificates from the investing public or received them in exchange for certificates in other mortgages.

Prudence Realization Corporation, the petitioner here, was organized pursuant to a plan of reorganization for

Prudence under Section 77B of the Bankruptcy Act. The plan was proposed by Reconstruction Finance Corporation, the largest single creditor of Prudence, after a finding had been made that Prudence was insolvent. The plan provides that the stockholders of Prudence have no interest in the liquidation of its assets and provides for the distribution of the proceeds of such liquidation to creditors only. Petitioner is therefore a creditors' realization corporation and in no way represents interests of the old stockholders. The status of petitioner is set forth in detail in *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, at pp. 91, 92 (R. 152).

The Tigo certificate issue was created in the general manner above described. By agreement dated July 17, 1935, Prudence, with its own funds made a loan and received a bond secured by a mortgage in the principal amount of $500,000 on the real property at 10 West 86th Street, New York City, which is now owned by the present debtor. The bonds and mortgages were assigned by Prudence to Prudence-Bonds Corporation and subsequently the latter corporation issued certificates of participation in the mortgage. Prudence-Bonds Corporation delivered the bonds and mortgages to Central Union Trust Company, now Central Hanover Bank and Trust Company, as depositary under a letter of deposit (R. 13). Subsequently on December 13, 1937, by order of the United States District Court for the Eastern District of New York, in the reorganization of Prudence-Bonds Corporation, the mortgage was formally assigned to Central Hanover Bank and Trust Company as depositary (R. 13). Prudence upon its assignment of the bond and mortgage to Prudence-Bonds Corporation executed a guaranty of the payment of interest when due and the payment of principal when due or within eighteen months thereafter. Upon the assignment of the bond and mortgage, Prudence received no cash, but participation certificates were then issued by Prudence-Bonds Corporation, turned over to Prudence as compensation for its assignment of the bond and mortgage and in

turn sold by Prudence to various numbers of the investing public (R. 13, 14). At the time of the filing of the petition for reorganization of this debtor, certificates were outstanding in the aggregate principal sum of $403,975 (R. 14). Prudence, prior to the filing of its petition for reorganization, had acquired certificates of the Tigo issue in the principal sum of $127,359.06 (R. 23, 24). These certificates were included in the assets of the insolvent estate, transferred to Prudence Realization Corporation on the consummation of the Prudence plan and prior to the institution of the present proceeding for the reorganization of this debtor. At the inception of this proceeding, therefore, Prudence Realization Corporation, petitioner, had been organized for the benefit of all of the Prudence creditors and held these certificates as a creditor of this debtor.

Upon the filing of the petition for reorganization of this debtor, an order was entered directing the filing of claims by creditors. A claim was filed on behalf of all certificate holders by Central Hanover Bank and Trust Company as depositary (R. 10, 11). A plan of reorganization was proposed by the trustee which included a compromise of the question of participation by petitioner (R. 102). Upon the hearing with respect to such plan, the District Court held that petitioner's certificates were subordinate and rejected the plan. Prior to the formulation of a new plan this Court decided *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, holding that certificates held by petitioner were entitled to parity of participation with other certificates where the proceeding for reorganization of the certificated mortgage was effected under Section 77B of the Bankruptcy Act (R. 103).

Thereafter respondents filed objections to the proof of claim filed by the depositary, upon the ground that such claim failed to discriminate against petitioner's certificates (R. 11). The facts were stipulated in the District Court upon such objection to the claim. The objections were overruled and the claim allowed, and on October 8, 1942, the District Judge entered an order providing that peti-

tioner's certificates were entitled to parity and to classification together with all other certificate holders (R. 74, 75). No appeal was ever taken from that order.

The trustee then proceeded to propose a plan of reorganization which provided for parity of petitioner's certificates in accordance with the Court's earlier decision (R. 79). No objections were filed to that plan, to which petitioner consented, and the plan was confirmed on January 19, 1944, subject only to consummation upon the preparation of the necessary documents to carry out the provisions of the plan (R. 94-96). On March 10, 1944, the New York Court of Appeals decided *Ferris* v. *Prudence Realization Corporation,* 292 N. Y. 210, which apparently held that where the question of parity was reserved for adjudication by a court of competent jurisdiction under a plan of reorganization under Section 77B of the Bankruptcy Act and the proceeding is closed in the Federal Court, the question of parity is determinable as a matter of state law and under state decisions petitioner's certificates were held to be subordinate. Upon the decision of the New York Court of Appeals, respondents proposed amendments to the plan of reorganization in this proceeding (R. 99). Such amendments provided that the question of parity be reserved for adjudication by a court of competent jurisdiction and further specifically provided that such ultimate determination should be "on the basis of the rights existing immediately prior to the filing of the petition (for reorganization) herein" (R. 107).

Upon the occasion of such amendments, therefore, the plan of reorganization had been confirmed and adjudication had been made as to the status of petitioner's certificates and no appeals had been taken from either the order of confirmation or the order adjudicating petitioner's status. The amendments sought to alter the finality of such determination not by securing a ruling that petitioner's certificates were subordinate but to postpone the adjudication in such language as to bring the case squarely within the New York Court of Appeals decision which

if upheld would result in a determination of subordination. Petitioner objected to the approval of these amendments and the District Court rejected them (R. 114).

The order of consummation of the plan of reorganization was entered on May 31, 1944 (R. 125), and the plan was thereafter consummated. On July 14, 1944, an appeal was taken from the order of confirmation (R. 97); on June 28, 1944, an appeal was taken from the order of consummation (R. 126), and from the order rejecting the proposed amendment (R. 126). A petition for a writ of certiorari from the decision of the New York Court of Appeals in the *Ferris* case was granted by this Court, and on January 29, 1945, this Court affirmed the decision of the New York Court of Appeals in *Prudence Realization Corporation* v. *Ferris*, 65 Sup. Ct. 539.

Upon the determination by this Court in the *Ferris* case respondents moved in the District Court for an order reconsidering and rejecting the proof of claim filed by Central Hanover Bank and Trust Company as depositary, upon the ground that the new equities demonstrated by the opinion of Mr. Chief Justice Stone in the *Ferris* case required a determination that petitioner's claim was subordinate (R. 128-135). Petitioner opposed the granting of this application and the District Judge denied the motion (R. 139). An appeal was thereafter taken by respondents to the Circuit Court of Appeals from this order (R. 141). By stipulation all four appeals were consolidated. The Circuit Court of Appeals dismissed the appeal from the order of confirmation as being jurisdictionally defective (R. 159). The Court also rejected the argument of respondents that the law of the State of New York is controlling on the question of status but held that it was bound by the concurring opinion of Mr. Chief Justice Stone in the *Ferris* case and upon that basis held petitioner's certificates to be subordinate. In recognition, however, of the fact that the amendments proposed by respondents were not sufficient to justify the reversal, the Circuit Court relied upon the general prayer for relief in the motion papers as authorizing the

Circuit Court of Appeals to go beyond the amendments and to provide for the subordination. The comment by Judge Frank in his opinion that the question of resubmission to certificate holders was not presented because it was evident that the consents received to the confirmation of the plan exclusive of those filed by petitioner were sufficient to secure such confirmation, was not supported by the record. The facts demonstrate that petitioner holds 31% of the outstanding certificates and it is obvious that almost 100% consents would have been required in order to permit the confirmation of the plan without counting petitioner's consents. In view of the decision by the Circuit Court of Appeals that subordination could be decreed by reversing the order rejecting the amendments, the Court did not consider the remaining two appeals dealing with the order of consummation and the order refusing to reconsider and reject the claim filed on behalf of petitioner (R. 159).

Specification of Errors

The Circuit Court of Appeals erred

1. in holding that the certificates of participation in the Tigo Certificate Issue held by petitioner are subordinate to certificates held by others;

2. in holding that the district judge abused his discretion in rejecting the amendments to the trustee's plan, proposed by respondents;

3. in holding that the general prayer for relief contained in the petition proposing specific amendments to the plan which would postpone adjudication of petitioner's status, constituted sufficient basis for the appellate court to make a present final determination adverse to petitioner, without affording petitioner an opportunity to present any further proof as to the issues presented by any request for such final determination;

4. in holding that after adjudication of petitioner's status and the confirmation of a plan, where consummation required only the preparation, execution and delivery of formal documents specified in the plan, and neither the adjudication nor the order of confirmation can be appealed from, amendments may be approved which adversely affect petitioner's status, over petitioner's objection.

Reasons Relied On for the Allowance of the Writ

1. The decision of the Circuit Court of Appeals is in conflict with the decisions of this Court in *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, and in *Sampsell* v. *Imperial Paper & Color Corporation*, 313 U. S. 215. The determination by the Circuit Court of Appeals rests entirely upon the concurring opinion by Mr. Chief Justice Stone in *Prudence Realization Corporation* v. *Ferris*, 323 U. S. 650. Apparently the Circuit Court of Appeals recognized the effect of the *Geist* case, but felt obliged to follow the concurring opinion in the *Ferris* case, although the majority of this Court, after determination that state law was there controlling, had clearly stated in the opinion of Mr. Justice Frankfurter, that no indication would be made as to whether the result would be different if the federal rule for distribution to creditors was applicable. *Prudence Realization Corporation* v. *Ferris*, *supra*, at page 542.

In the *Ferris* case, Mr. Chief Justice Stone distinguished the *Geist* case upon two grounds: 1. that in the *Ferris* case as distinguished from the *Geist* case, Prudence did not acquire its interest in the mortgage as an original investment before it sold and guaranteed certificates, and, 2. that in the *Ferris* case it did not acquire its certificates independently of its guaranty. The Chief Justice thereupon concluded that petitioner was affected by the taints of Prudence despite the fact that petitioner represents all

of the creditors of the insolvent Prudence Company including present respondents, and applied the rule of subordination theretofore limited to solvent sureties.

The Chief Justice, in his opinion, overlooked the fact that the first basis for distinction was not available, for all of the certificate issues involved in the *Geist*, the *Ferris*, and the present cases were created in the same fashion. In each case Prudence made the original mortgage loan with its own corporate funds. The sale of certificates in the mortgage could take place only after such investment by Prudence, which was a mortgage company making its profit from bonuses for making the mortgage loans. *In re The Prudence Company, Inc.* (C. C. A. 2d, 1938), 98 F. (2d) 559, 560. The participation of the mortgage, the guaranty and the sale of participations was for the purpose of securing additional funds for further investment for further profit.

As to the second distinction, resting upon the purpose of the repurchase of certificates at or after maturity, the Chief Justice apparently gave no weight to the arguments advanced in the *Ferris* case, and now argued here, that Prudence was insolvent at the time of such repurchase; that the purpose of the repurchase was to postpone maturity of its obligations or to pay them off at a discount. It is to be noted that insolvency at the date of acquisition by Prudence was argued by certificate holders' representatives in the *Ferris* case, and is here urged by the same interests.

And it is clear that insolvency is properly the argument to be made by creditors to show improper use of funds by the debtor, in this case the guarantor. However, it seems equally clear that that argument, particularly under the Bankruptcy Act, is the basis for rights urged by *all* creditors of the guarantor, not for one group as against the remaining creditors holding the same status and the same claims.

In urging that the Chief Justice, in the *Ferris* case, and the lower court here, were in error, petitioner is saying

no more than that the guarantor's insolvency at the time of repurchase and at the present time, is a fact to be considered in determining the equities existent between the other certificate holders and petitioner as creditors of the debtor reorganized in the present proceeding.

In *Sampsell* v. *Imperial Paper & Color Corporation*, *supra*, this Court said at page 219:

> "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete. *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 59 S. Ct. 543, 83 L. Ed. 669; *Pepper* v. *Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281; *Bird & Sons Sales Corp.* v. *Tobin*, 8 Cir., 78 F. 2d 371, 100 A. L. R. 654. But the theme of the Bankruptcy Act is equality of distribution. Sec. 65, sub. a, 11 U. S. C. A. Sec. 105, sub. a; *Moore* v. *Bay*, 284 U. S. 4, 52 S. Ct. 3, 76 L. Ed. 133, 76 A. L. R. 1198. To bring himself outside of that rule an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice."

The burden, therefore, is upon respondents to show that the failure to subordinate petitioner's certificates would constitute an injustice. Respondents seek to sustain that burden by the assertion that Prudence, as guarantor, being insolvent, acquired certificates in this mortgage by exchanging them for certificates of other issues with later maturities, or by buying them in the open market through a concealed brokerage account at less than par. From these facts they conclude the rule applied in *United States* v. *National Surety Company*, 254 U. S. 73; *Jenkins* v. *National Surety Company*, 277 U. S. 258; *American Surety Co.* v. *Westinghouse Electric Mfg. Co.*, 296 U. S. 133, involving *solvent* sureties must be invoked to subordinate petitioner, the corporation organized for the exclusive benefit of the guarantor's creditors.

Respondents rely therefore upon equities between a creditor and a solvent guarantor to justify their priority here, though the determination here requires an adjudication of equities between one group of guaranty creditors and all other creditors of the insolvent guarantor.

Respondents have argued here, as they did in the *Ferris* case, that petitioner has no greater rights than Prudence had. Were the question of title to these certificates involved in this case, then the question of the title of a successor would be important, and perhaps conclusive. But there is no dispute as to title, nor is that issue presented. It is clear that a bankrupt's purchaser acquires no greater *title* than the bankrupt had. It is equally clear, however, that a bankruptcy trustee has greater *rights* than the bankrupt had, for he receives the rights not alone of the bankrupt but of his creditors as well. Bankruptcy Act, § 70c. And upon reorganization of an insolvent, exclusively for the benefit of its creditors, to limit their rights to those of the insolvent debtor is to adjudicate a reduction in rights not contemplated by the statute nor by the plan of reorganization.

If, as argued by respondent, Prudence was insolvent when it repurchased the certificates held now by petitioner, then Prudence utilized funds of all creditors either to prefer those Tigo certificate holders who received cash, or to defraud such holders who accepted certificates of other issues, thereby consenting to the postponement of the maturity of the guaranty obligation. The certificates which they accepted could have been sold by Prudence for cash which would have been available to all creditors. By the acceptance of such certificates and such postponement, these original Tigo certificate holders remained guaranty creditors, who are included in those represented by petitioner and who are now being subordinated as a matter of "equity".

Had Prudence not repurchased the certificates, the holders of such certificates would be creditors of this debtor with a status of parity with respondents. Does the

repurchase of these certificates by Prudence at a time when it was insolvent give the remaining Tigo certificate holders a priority position at the expense of the selling certificate holder who now is one of the remaining creditors of Prudence? Is there any rule of equity which will even attempt to justify the subordination of these Prudence creditors as a further penalty for their gullibility in exchanging their certificates for later maturities, which joined the Tigo certificates in their unenforcibility?

As against the argument that the repurchases here were for the purpose of reducing or postponing performance of Prudence's guaranty obligation, an analysis of such purchases is illuminating. It must be noted that at the time of these repurchases the 18 months' clause had been invoked (R. 14). Enforcement of Tigo principal obligations maturing October 1, 1932, was deferred until April 1, 1934. The precarious financial condition of Prudence assumed by Mr. Chief Justice Stone in the *Ferris* case would indicate the necessity for conserving cash to meet enforceable obligations such as interest.

The following is a breakdown of the acquisitions (R. 23, 24):

REINVESTMENTS		
In certificates	$48,709.06	
In guaranteed mortgages	21,000.00	$ 69,709.06
CASH		
At par flat or with interest	$44,800.00	
At 95 flat or with interest	2,500.00	
Pender-Buckbee-Merriam Account—at 76½ to 83	10,350.00	57,650.00
		$127,359.06

The cash outlay for the $57,650 face amount of certificates was $55,574.06, or a saving of $2,075.94. Prudence is therefore being charged with having used $55,574.06 of

badly-needed cash to pay off unenforcible guaranty obligations, in order to postpone its guaranty obligation of $69,709.06. Ignored is the fact that the certificates of other issues accepted as reinvestments here were salable to the public at par and accrued interest, and that the cash which Prudence which have received upon such sale could have been utilized for investment by Prudence or as additional funds to pay enforcible obligations.

When Prudence applied for a loan from Reconstruction Finance Corporation, it did not contemplate cessation of business. It sought to preserve real estate values, the integrity of mortgage investments and the preservation of the market for reinvestments (R. 16). It had faith in the revival of values and continued utilization of real estate as a form of investment. Preservation of clientele was essential to assure Prudence of its share of such future business. Repurchase, and the securing of reinvestments by its customers, was carrying out its usual business policies. To relieve distress in particular instances, Prudence said par. The certificate holder was satisfied that Prudence was keeping its word to repurchase the certificate when requested. Had it been Prudence's purpose to reduce its guaranty it would have refused to buy from the holder directly and forced him to sell in the open market where Prudence could have acquired them at a substantial discount.

Although great emphasis previously has been placed upon the so-called "concealed" Pender-Buckbee-Merriam brokerage account as indicating a form of double-dealing, the facts belie the contention. Concealment of a brokerage account is not a novelty. No security holder selling to a broker knows who the true buyer is. What concealment was effected here was between the employees of the brokerage firm and Prudence. The selling certificate holder was no more ignorant of the buyer here than in any other case. Undoubtedly Prudence wasn't the only purchaser of these certificates in the market. By buying in competition with others Prudence wasn't hurting the certificate holder, for this would

keep the price up, not down. Buying at a discount was good business for it would ultimately represent a profit when values were re-established.

Prudence was in error as to the imminence of real estate recovery. The real estate depression continued, and Prudence's hopes for profitable continuance in business were proved illusory. That error is being visited upon all of its creditors. The cash which it might have preserved for ultimate pro rata distribution to all of its creditors was dissipated.

Petitioner, as the creditors' realization corporation, here seeks the protection of the interests of all such creditors, not by reason of the reorganization of Prudence as granting additional rights, but because the insolvency of Prudence at the time of acquisition of these certificates and its subsequent default on all of its guaranty obligations demonstrate that the present Tigo certificate holders can show no equitable grounds for subordinating these other creditors in their participation in this asset of the Prudence estate.

2. The decision of the court below in decreeing subordination has amended the confirmed plan of reorganization without regard to the statutory provisions prescribing the procedure for amendment. The amendments proposed by respondents were specific. The language was set forth in detail (R. 106 et seq.). The purpose was clear—to alter the determination made in 1942 that petitioner's certificates were on a parity, and the provisions of the confirmed plan carrying out that determination (R. 79)—and to reserve the question for future determination. No final adjudication was requested, and the form of the amendments contemplated subsequent litigation on the issue, with the opportunity for the submission of additional proof if such be deemed necessary by any party.

To be sure respondents took the precaution of providing that such subsequent determination should be made on

the basis of "the rights existing immediately prior to the filing of the petition (for reorganization) herein" (R. 107).

The district court denied the motion for the approval of the amendments (R. 114). Although Bankruptcy Act, Chapter X, Section 222, provides for amendment of a plan before or after confirmation, such amendments must conform to the requirements of the statute that the plan as amended shall be "fair and equitable, and feasible" (Chapter X, Section 221(2)). An amendment which seeks to fix rights as they were prior to the proceeding, and without regard to such creditor's rights as they exist under the Bankruptcy Act, cannot be deemed to be a proper amendment, for, over objection by the creditor, any plan as so amended would contradict the statutory direction that the plan, as confirmed, must comply with the provisions of Chapter X, Bankruptcy Act, Section 222(1).

The Circuit Court of Appeals reversed the district court, relying upon the prayer for general relief contained in the motion, which it deemed sufficient to raise the issue of status upon the appeal. That basis was inserted by the Circuit Court of Appeals, for the argument was not advanced upon the appeal by respondents.

The distinction between the reservation of a question for subsequent determination upon a trial of the issues, and the final determination of the question summarily, is manifest. Bankruptcy Act, § 222 provides for amendments to plans under Chapter X, as follows:

> "Sec. 222.—A plan may be altered or modified, with the approval of the judge, after its submission for acceptance and before or after its confirmation if, in the opinion of the judge, the alteration or modification does not materially and adversely affect the interests of creditors or stockholders. If the judge finds that the proposed alteration or modification, filed with his approval, does materially and adversely affect the interests of creditors or stockholders, he shall fix a hearing for the consideration, and a subsequent time for the acceptance or rejection, of such alteration or modification. The requirements in regard to notice of hear-

> ing, to submission to the Securities and Exchange Commission, to acceptance, to filing and hearing of objections to confirmation and to the confirmation, as prescribed in article VII of this chapter in regard to the plan proposed to be altered or modified, shall be complied with."

After approval of an amendment which is materially adverse, notice of hearings must be given as prescribed by the statute. The preliminary offer of the amendments does not require such notice, but it is evident that the statute requires that an opportunity be given to possible objectors to present proof as well as their objections as to the amendments.

A general prayer for relief cannot amend the statute, nor may the Circuit Court of Appeals by decree accomplish the same result. The decision of that Court in this case is no less than such an amendment, for it has converted the reservation amendment to an amendment providing for subordination, has approved such amendment and has also determined that the plan as so amended need not be resubmitted to creditors (R. 159). In the latter respect the factual conclusion of the Circuit Court of Appeals that the consents necessary for the adoption of the plan were "apparently sufficient" without including petitioner's consent, is gratuitous and inaccurate.

By its decision the Circuit Court of Appeals has placed no limitations upon the reorganization court's power to write provisions into a plan, for once an amendment is offered in specific terms, but with a prayer for such other and different relief as to the Court may seem proper, the Court, on its own motion and without further hearings may not alone reject the proposed amendment, but may change interest rates, amortization provisions, maturities, capitalization or any other provisions of the plan. If that has been the purpose of Congress, the specific provisions for amendment, for notice and for hearings would not have been enacted.

The result here is that the Circuit Court of Appeals has established a practice which constitutes a judicial modification of the statutory procedure for amending plans of reorganization under Chapter X of the Bankruptcy Act, and which raises an important question of bankruptcy administration requiring review by this Court.

3. The Court below in subordinating petitioner's certificates erroneously has applied, to an insolvent guarantor, the rule heretofore applied exclusively to solvent sureties. *United States* v. *National Surety Company*, 254 U. S. 73; *Jenkins* v. *National Surety Company*, 277 U. S. 258; *American Surety Co.* v. *Westinghouse Electric Mfg. Co.*, 296 U. S. 133. Although the Court did not refer specifically upon those decisions, its reference to the concurring opinion of Mr. Chief Justice Stone in the *Ferris* case, supra, establishes the basis for decision.

The pertinent portion of the Chief Justice's opinion in the *Ferris* case appears in 65 Sup. Ct. at page 542:

> "Petitioner did not, as in the Geist case, acquire its interest in the mortgage as an original investment before it sold and guaranteed certificated shares in the mortgage, nor did it acquire its own certificates independently of the performance of its obligation as a guarantor of the certificates. Petitioner is here in the position of a subrogee of a claim whose payment it has guaranteed. For it acquired its claim to participate in the mortgage through performance of its guaranty, by purchase, after default, of the certificates of participation which it had guaranteed.
>
> As we recognized in the Geist case, and were at pains to point out, 316 U. S. at page 96, 62 S. Ct. at page 983, 86 L. Ed. 1293, such a case is within the rule of United States v. National Surety Co., 254 U. S. 73, 76, 41 S. Ct. 29, 30, 65 L. Ed. 143; Jenkins v. National Surety Co., 277 U. S. 258, 48 S. Ct. 445, 72 L. Ed. 874; American Surety Co. v. Westinghouse Electric Mfg. Co., 296 U. S. 133, 56 S. Ct. 9, 80, L. Ed. 105, 'that a solvent guarantor or surety of an insolvent's obliga-

> tion will not be permitted, either by taking indemnity from his principal or by virtue of his right of subrogation, to compete with other creditors payment of whose claims he has undertaken to assure, until they are paid in full.' "

The treatment of petitioner as being the equivalent of Prudence, the guarantor, is unfortunate, for the facts—the reorganization of Prudence for the exclusive benefit of its creditors, and as pointed out above, the acquisition of the rights of such creditors as well as of Prudence—show a basic distinction which the identity of treatment in the opinion disregards.

Petitioner here was the petitioner in the *Geist* case, *supra*. Its status remains what it was in that case, as representative of all creditors of Prudence and as protector of the rights of such creditors referred to by the Chief Justice in his opinion in the *Geist* case, *supra*, at page 97:

> "The Prudence Company is not solvent. Its property is being liquidated in bankruptcy where all the claimants on its present and other guaranty obligations are entitled to share equally in its unpledged assets. Denial of the right to prove its claim, which is an asset in which all of Prudence's creditors are otherwise entitled to share, will serve only to divert this asset from all creditors to one class of creditors, the Zo-Gale certificate holders, and thus give to them the exclusive benefit of a security for which they have not bargained. Allowance of the Prudence Company's claim does not involve any breach of its duty as guarantor. Nor does it deprive certificate holders of their right to share in this asset pari passu with the other creditors, or of any right, legal or equitable, to which they are entitled by virtue of their position as guaranteed creditors. See Hampton v. Phipps, supra; Prairie State Nat. Bank v. United States, 164 U. S. 227, 17 S. Ct. 142, 41 L. Ed. 412; Henningsen v. United States Fidelity & Guaranty Co., 208 U. S. 404, 28 S. Ct. 389, 52 L. Ed. 547."

As to the solvent surety cases, their applicability to petitioner rests upon an erroneous view as to the nature of Prudence's business and its acquisition of the certificates here involved.

Prudence was engaged primarily in the business of making mortgage loans. As the Circuit Court of Appeals said in *In the Matter of The Prudence Company, Inc.* (C. C. A. 2d, 1935), 79 F. (2d) 77 at page 80, speaking about Prudence, "Although a corporation organized under the Banking Law as an investment company has power to guarantee the mortgages and participation certificates which it sells, the element of insurance is but incidental to its mortgage business, * * *." It used its own funds to make loans secured by mortgages on real estate. At the time of making the loan it secured a "bonus" of approximately 5% from the borrower by actually advancing 95% of the face amount of the mortgage. *In re The Prudence Company, Inc.* (C. C. A. 2d, 1938), 98 F. (2d) 559, 560. As any other mortgagee, it secured an appraisal of the property (R. 22) as well as a title policy (R. 21). Thereafter, to secure additional funds for use in making further mortgage loans for profit, it created the certificate issues like the one here involved. It split up its mortgage into many parts and sold these parts of the mortgage to investors. To facilitate the sale it guaranteed to each purchaser of a portion of the mortgage the payment of principal within 18 months after the certificate matured and interest when due. Interest was guaranteed at the rate of 5½% (R. 29). Its sale of certificates permitted it to realize upon the bonus received from the mortgagor and to use that money as well as the actual cash loaned.

The only basis upon which Prudence could continue in business for profit at any time was to maintain a group of investors in the mortgages which it received on making new loans. Its practice therefore at all times was to keep its customers, or "clients" as they were called (R. 39, 40, 54, 69, 70). Its practice before January, 1932, as well as

after, was at any time on application, to lend to holders of the certificates up to 90% on the security of the certificates, or to repurchase them at a 10% discount (R. 40). At or near the maturity of any issue it sent salesmen out to try to sell new issues in exchange for the maturing certificates (R. 65, 66).

On January 1, 1932, the 18 months' clause was invoked to postpone the principal guaranty obligation (R. 41). The Tigo mortgage payment due on October 1, 1932 was not paid. The result was that with respect to certificates which matured on that date the 18 months' deferment began to operate. The guaranty of principal of such certificates did not mature until 18 months thereafter, or April 1, 1934.

In February, 1932, Reconstruction Finance Corporation approved a loan of $20,000,000 for Prudence (R. 50, 51). The securing of the loan was consistent with Prudence's continuance in business. Its practice with respect to repurchase of its own securities continued. Efforts to secure reinvestment by the client were made as usual, and the fact that there was a reinvestment did not mean that the client had first insisted on receiving his money (R. 66, 67). Prudence's acquisition of certificates here did not differ from its acquisition of certificates of other issues; they were acquired as part of the regular practice of the company (R. 69, 70).

When Prudence had originally sold the mortgage for 100%, after having paid only 95%, it made a profit. When it reacquired certificates at a 10% discount it made a further profit. When it reacquired it by selling a portion of another mortgage it was again realizing a profit on the new mortgage. That was its business.

Prudence was not a surety company. As indicated, its business for profit was not based upon receiving a premium for lending its credit, its profit to be gained when its liability on its guaranty did not mature. That was the business of the surety companies involved in *United States* v. *National Surety Company; Jenkins* v. *National Surety*

Company; and *American Surety Co.* v. *Westinghouse Electric Mfg. Co.*, all *supra.* There the first connection between the surety and the assets of the primary obligor arose upon default by the obligor. There the surety's bond was required before the contractor could secure the contract or before the bank could receive the deposits. Here Prudence made an investment by lending money. The guaranty was subsequent in time and represented its contractual obligation to the purchasers of shares in that investment that the investment would be paid. As this Court said in the *Geist* case at pages 96, 97:

> "By that contract the guarantor pledged only its personal obligation for the payment of the certificates. It gave to the certificate holders no lien upon or other priority in its interest in the mortgage more than to its other assets."

See also, *Kelly* v. *Middlesex Title Guarantee and Trust Company,* 115 N. J. Eq. 592, aff'd on this opinion, 116 N. J. Eq. 574; (1941) 55 Harv. L. Rev. 283, 285; (1941) 41 Yale L. J. 315, 318; (1942) 40 Mich. L. Rev. 739, 740.

The purchaser of the certificate received not just a surety bond from Prudence but a share in a mortgage. That was a salable asset in his hands as well as in the hands of Prudence, with or without the guaranty. If the property was worth less than the mortgage and cost of acquisition, the deficiency was chargeable against the guarantor's assets; not against any special asset, but against the general assets based upon the unsecured guaranty contract. That was true of every guaranty contract of Prudence.

When Prudence became insolvent its general assets, including the certificates owned by it in this issue, became the source of payment of all of its guaranty claims. No guaranty creditor was entitled to any preferential treatment as against any other, and no property justifiably could be taken out of the general estate to transform the Tigo certificate holder's guaranty obligation into a secured debt merely because the insolvent guarantor having once sold

its original investment had repurchased a portion of it. There is no doubt that if Prudence had again resold the reacquired certificates, with or without the guaranty, the purchasers would have been entitled to parity and the cash received would have been part of the fund presently available to pay all of the insolvent guarantor's debts.

The surety cases alone were relied upon for subordination by the Chief Justice without giving effect to the facts as they may affect the application of the equitable doctrine set forth in the surety cases. That the doctrine is equitable is unquestioned. However, an equitable rule, applied without regard for factual variations, is no longer equitable in character. It is inconsistent with every concept of equity that any of its rules should be applied arbitrarily. Yet that is the result of the decision here, for in decreeing subordination the Court below has disregarded the nature of petitioner's functions and arbitrarily applied the rule in the solvent surety cases.

In the surety cases the rights in controversy were those existing between the solvent surety and those it had insured as against assets of an insolvent primary obligor. No competing interests were involved. The equities were limited therefore to those parties.

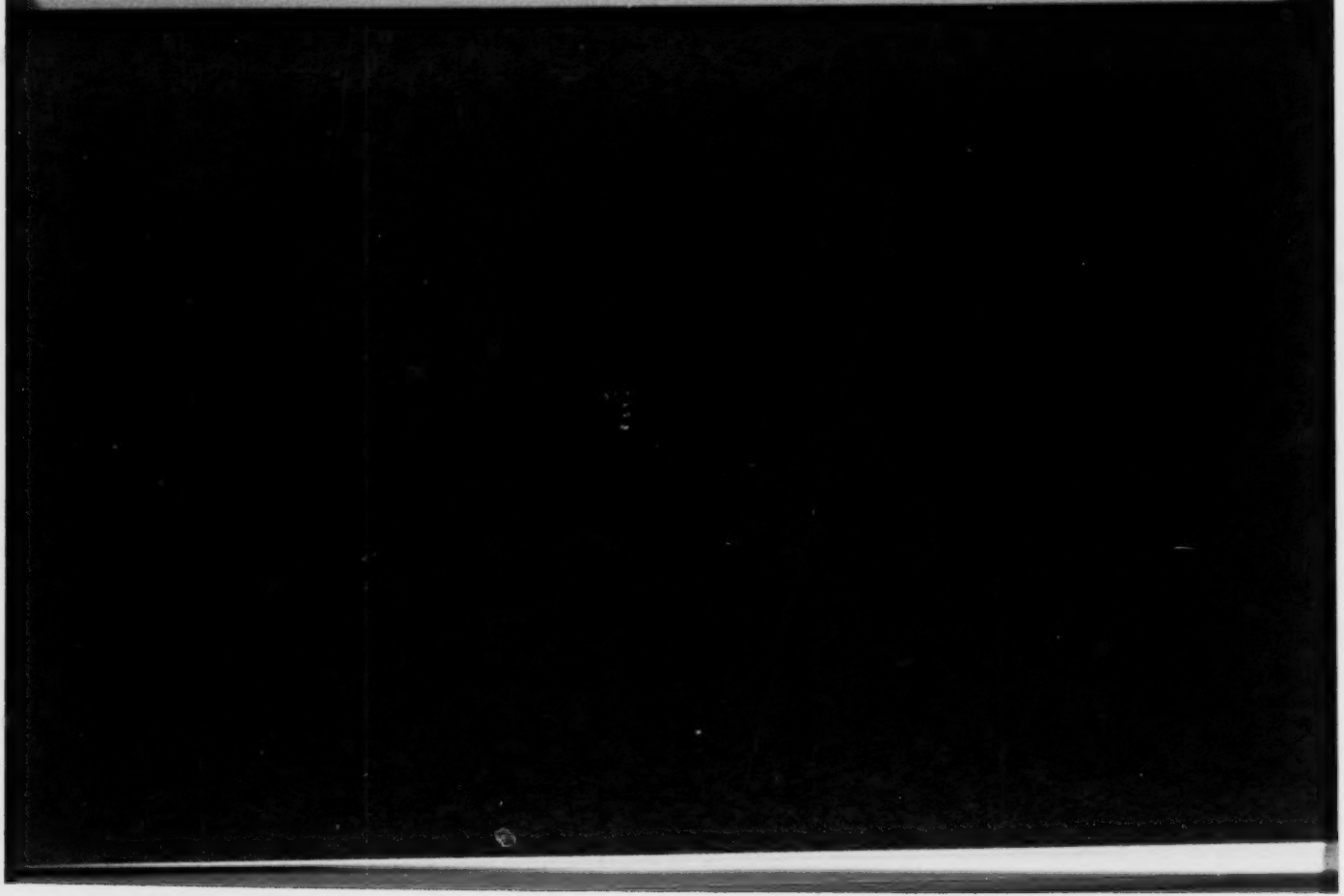
In the present case, the argument for subordination rests upon the assertion that since the guarantor, when it was either insolvent or imminently insolvent, used its creditors' assets to pay off part of its guaranty obligation here, the remaining holders of certificates in this issue are entitled to the benefit of the reduction of the debt at the expense of the remaining Prudence creditors. The rights involved here therefore are those existing between one group of guaranty creditors and all of the other creditors of the guarantor having similar claims. The right of the guarantor's creditors to pro rata distribution of the insolvent guarantor's assets as a matter of equity must be conceded. These equities, not present in the solvent surety cases, are competing here with respondents' claim for preference.

CONCLUSION

WHEREFORE, it is respectfully submitted that this petition for a writ of certiorari should be granted to review the decision and order of the Circuit Court of Appeals for the Second Circuit.

IRVING L. SCHANZER,
Counsel for Prudence Realization Corporation, Petitioner.

July, 1945.



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CITATIONS

662345—45——1

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 223

IN THE MATTER OF 1934 REALTY CORP., DEBTOR

PRUDENCE REALIZATION CORPORATION, PETITIONER

v.

THE HURD COMMITTEE, THE PETITIONING CREDITORS, AND CARROLL DUNHAM, 3RD, AND EDWARD K. DUNHAM AS TRUSTEES OF THE ESTATE OF DAVID DOWS, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

PRELIMINARY STATEMENT

The Securities and Exchange Commission, pursuant to Section 208 of the Bankruptcy Act (Act of June 22, 1938, c. 575, sec. 1, 52 Stat. 894, 11 U. S. C. sec. 608), became a party to the present proceedings for the reorganization of 1934 Realty Corp., debtor, under Chapter X of the Bankruptcy Act in the District Court for the Southern District of New York (R. 3). The Commission participated in the appeals to the court below

from 4 separate orders of the district court. These appeals, which were consolidated, involved a determination of the relative participation rights in a bankruptcy proceeding of guaranteed mortgage participation certificates held in the mortgage on debtor's property, and resulted from the orders of the district court granting parity of treatment to the certificates held by the petitioner, successor to the guarantor.[1] The court below among other things reversed the order of June 27, 1944, denying respondents' motion for approval of proposed alterations and modifications in the confirmed plan and for general relief, and directed that the certificates reacquired by the guarantor be subordinated to the publicly held certificates (R. 159).

OPINION BELOW

The opinion of the circuit court of appeals (R. 156–9) has not yet been reported. The opinions of the district court (R. 73, 139) are not reported.

JURISDICTION

The decree of the circuit court of appeals was entered June 22, 1945 (R. 159–60). The petition for a writ of certiorari was filed July 13, 1945. Jurisdiction of this Court is invoked under Sec-

[1] The same general problem was before this Court in *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, and *Prudence Realization Corporation* v. *Ferris*, 323 U. S. 650.

tion 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The principal question presented is whether, under Chapter X, holdings by an insolvent guarantor of mortgage participation certificates guaranteed by it should be subordinated to holdings of public certificate holders where the guarantor's holdings were acquired after default or when default was imminent and in an effort to reduce or defer its obligations as guarantor.

STATEMENT

We refer only to the facts we believe to be of particular importance to an understanding of the Commission's views. In substance those facts, as the Court below stated, "for all practical purposes are the same as those in the *Ferris* case" (*Prudence Realization Corporation* v. *Ferris*, 323 U. S. 650).[2]

In 1925, by an agreement between The Prudence Company, Inc. ("Prudence"), which was engaged in the mortgage-guaranty business, and Tigo Realty Co. Inc. (the then-owner of the apartment house and lot of the Debtor, 1934 Realty Corp.), five bonds and mortgages on this property were consolidated and extended so as to mature

[2] The present record incorporates by stipulation the testimony given in the *Ferris* case concerning the methods of acquisition of certificates by Prudence (R. 18, 37–70).

October 1, 1932[3] (R. 13, 20–21, 26–27). Prudence sold to the public certificates of participation in the consolidated mortgage and guaranteed to the purchasers the payment of interest thereon when due and of the principal when due or within eighteen months thereafter (R. 14, 25–26, 39).

Toward the end of 1931, Prudence faced maturing guaranty liabilities in the following year of approximately $23,000,000. In 1933 the maturities would amount to approximately $33,000,000, whereas in 1931 the maturities were only about $875,000 (R. 17). Its cash and asset position was such as to make the meeting of these maturities highly uncertain. The balance sheet as of December 31, 1931 showed cash of $783,738.08, marketable securities listed at $168,045.25 and notes and receivables of $1,563,459.63 (R. 31–2). Recognizing the Company's precarious financial condition, the executive committee of the board of directors, in January 1932, invoked the grace clause contained in its guaranty agreements

[3] Approximately ¾ of the mortgage, which totalled $500,000, was based on a direct loan by Prudence to Tigo (R. 20–21). Prudence assigned the consolidated bond and mortgage to Prudence-Bonds Corporation. By various agreements, a senior participation in said mortgage to the extent of $470,000 was created, which senior participation was held by Central Hanover Bank and Trust Company as depositary, and later assigned to it by Prudence-Bonds. The junior interest of $30,000 has been satisfied. Prudence-Bonds issued certificates of participation in the mortgage. Of these certificates, $403,975 are presently outstanding (R. 13–14).

and suspended payments of principal to certificate holders for a period of 18 months, while continuing to make interest payments (R. 14–15, 41). During the following month of February, the company applied to the R. F. C. for a loan of $25,000,000, of which somewhat less than half ($12,000,000) was to be used to renew selected maturing mortgages guaranteed by it, to prevent a flood of foreclosures which would depreciate real estate values further and adversely affect the guaranty liabilities (R. 15–16).

While a loan to the extent of $20,000,000 was granted by the R. F. C. in the same month, it does not appear that Prudence revoked the suspension of principal payments or attempted to renew any of the mortgages which were approaching maturity. Instead, the company took steps to attempt to reduce or postpone its guaranty liabilities. In addition to its customary practice of asking holders of maturing certificates to exchange them for certificates of later maturity, the company set up a committee to consider requests of individual holders for payment of their certificates in cash and established a concealed brokerage account, the so-called Pender-Buckbee-Merriam account, for the purchase of certificates on the market[4] (R. 41–2, 44–5, 54–5). Through such

[4] This account was created in order to purchase securities from brokers at substantial discounts. The previous practice of the company had been to discourage purchases through brokers, preferring to deal directly with customers, and it

methods the guarantor, between August 1932 and January 1933, covering a period of about 2 months before and 4 months after the default in the payment of the principal on October 1, 1932, acquired $127,359.06 face amount of Tigo certificates (R. 14, 23–24) or approximately 31.3% of the $403,975 of certificates outstanding [5] (R. 14). Of the total of certificates acquired, approximately $90,000 face amount were obtained by exchange either for another certificate of like face amount and later maturity (R. 14) or in some cases for part payment in cash and another certificate for the balance.[6] $26,000 were purchased directly from holders for cash at varying discounts ranging from accrued interest to 5 points plus accrued interest, except for one certificate of $1,500 which was purchased at par plus accrued interest just

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had advertised to its security holders that it would attempt to make purchases directly from them (R. 40, 45). The account was known only by a number and its use was secret and concealed (R. 52, 45).

[5] The earliest acquisition of Tigo certificates by Prudence was on August 11, 1932, when a $2,500 face amount certificate was exchanged to the extent of $500 for a certificate in another issue of later maturity, and the balance repurchased by Prudence at par and interest. The next acquisitions prior to default were effected from September 13 to September 30, 1932 by exchange, purchase, and part exchange and part purchase and totalled $24,609.06 in face amount of certificates. The balance of the certificates was acquired from October 1, 1932 to January 27, 1933 (R. 23–24).

[6] $25,000 were obtained immediately prior to maturity, $5,000 on the date of maturity, and $60,000 after maturity and after default by the mortgagor (R. 23).

10 days prior to maturity. All of the certificates acquired by cash payment alone were purchased after maturity and after default except for the $1,500 certificate just mentioned, and a $1,000 certificate purchased on the maturity date[7] (R. 24). The remainder of $10,350 were acquired in the market through the Pender-Buckbee-Merriam account at discounts from 17 to 23 points exclusive of accrued interest (R. 24).

In 1935 Prudence went into Section 77B reorganization and in 1938 was adjudicated insolvent. Thereafter a plan for its reorganization was confirmed by the district court. The plan transferred to petitioner, successor to Prudence, all the assets of the defaulting guarantor, including the re-acquired Tigo certificates (R. 78). Petitioner which was never in reorganization is engaged in conserving and liquidating the assets it has received pursuant to the plan. See *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, 91–92. The principal other and largest creditor of Prudence is the R. F. C. (R. 35, 33).

An involuntary petition for the reorganization under Chapter X of the Debtor, 1934 Realty

[7] While prior to 1932 customers understood they might receive payment of the security at a slight discount (R. 40), the evidence discloses that during the period of financial stress each request for payment was separately considered by the committee and there is warrant for the inference that the committee sought to make purchases at the best prices obtainable where persons were evidently in need of money and might not be able to await the end of the 18 months' grace period (R. 53–5).

Corp., the present owner of the real property subject to the Tigo mortgage, was filed December 23, 1938 (R. 1). Thereafter, Central Hanover Bank and Trust Company, assignee of the mortgage, filed a claim on behalf of all the holders of Tigo certificates, including petitioner (R. 6–9). Objection was made to the right of petitioner to share in the proceeds of the mortgage on a parity with other certificate holders (R. 10–12). This objection was overruled and the claim allowed, by an order entered October 8, 1942 (R. 74–75), on the purported authority of *Prudence Realization Corporation* v. *Geist,* 316 U. S. 89 (R. 73, 103). The trustee accordingly proposed an amended plan of reorganization [8] providing parity of treatment for the petitioner-held certificates [9] (R. 76–91).

On March 10, 1944, the New York Court of Appeals in *Ferris* v. *Prudence Realization Corporation,* 292 N. Y. 210, decided that since the plan involved in that case reserved the question of parity for adjudication by a court of competent jurisdiction, state law governed and under its decisions subordination of the guarantor-held certificates was required. On the basis of this de-

[8] The trustee's original plan had proposed a compromise of the question whether these certificates should be subordinated (R. 102, 131). The district court rejected this plan, at that time ruling that petitioner's certificates were subordinate (R. 131).

[9] The plan was confirmed January 19, 1944 (R. 94–96). Respondents appealed from this order July 14, 1944 (R. 97).

cision, respondents on April 17, 1944 filed a motion to modify and amend the trustee's amended plan to reserve for a court of competent jurisdiction the determination of the status of the certificates held by the petitioner. This motion also contained a prayer for general relief (R. 99–109). The motion was denied June 27, 1944 (R. 114–15) and respondents appealed[10] (R. 126). The circuit court of appeals reversed the order of June 27, 1944 and directed subordination of petitioner's holdings. Certiorari is asked to review this decree.[11]

ARGUMENT

The principal issue is whether the decision of the court below is in accord with the doctrines laid down by this Court in *Prudence Realization Corporation* v. *Geist,* 316 U. S. 89, particularly in the light of the concurring opinion of Chief Justice Stone in *Prudence Realization Corporation* v. *Ferris,* 323 U. S. 650, which the court below

[10] On May 31, 1944, the district court ordered consummation of the plan (R. 115–25) and respondents appealed (R. 126). The final order appealed from, that of March 6, 1945 (R. 139–40), denied respondents' motion, pursuant to Sections 57 (k) and 102 of the Bankruptcy Act, 11 U. S. C. 93 (k), 502, for reconsideration and subordination of the claim based on the certificates held by petitioner to the claims of the publicly held certificates (R. 128–35, 141).

[11] The appeal dated July 14, 1944 from the order of January 19, 1944 was dismissed as "not timely." The court found it unnecessary to consider the questions raised by the other two appeals "as those appeals seek the relief which we grant on the appeal from the order of June 27, 1944" (R. 159).

followed. In our view the decision of the court below holding that the mortgage participation certificates reacquired by the guarantor should be subordinated to the publicly held certificates is correct. No conflict in the circuits exists and the issue does not call for further review.

1. The *Geist* case held that as a matter of federal law applicable in bankruptcy proceedings an insolvent guarantor's holdings of mortgage participation certificates guaranteed by it would not be subordinated to publicly held certificates of the same issue where such certificates "* * * were acquired independently of its guaranty" and "* * * are not derived from or an incident to it" (316 U. S. at page 96). That case, however, made it clear that the guarantor's holdings would be subordinated where there was an "equitable basis for requiring the surety or guarantor to postpone the assertion of rights which he derives from or are incidental to his suretyship, to the rights of creditors whom he has undertaken to secure * * *" (316 U. S. at page 96). In the *Geist* case, the guarantor was permitted to participate on a parity in a case where its holdings consisted in large part of a residue of unsold participations in the mortgage and the balance of a small amount acquired as a bona fide investment when default was not anticipated.

The instant case, however, presents facts not at all like those in the *Geist* case. The facts with

respect to the guarantor's holdings in the present Tigo issue show that those certificates were acquired by Prudence when default was imminent or after default and were acquired in an effort to reduce or defer its obligations as a guarantor. The situation is exactly the one envisioned in the *Geist* case as creating an equitable basis for requiring subordination and therefore the decision of the court below cannot be said to conflict with the *Geist* decision, as petitioner contends (Pet. 10), but rather to conform to the principles there enunciated (see R. 158–9).[12] Although this is clear from the specific language of the *Geist* case, it is made even clearer in the subsequent concurring opinion of the Chief Justice in the *Ferris* case. There the Chief Justice, who was the author of the opinion of this Court in the *Geist* case, distinguished the factual situations in the two cases and concluded that the facts in the *Ferris* case required subordination.[13] The remaining Justices did

[12] Petitioner contends (Pet. 10) that the decision of the court below is also in conflict with *Sampsell* v. *Imperial Paper Corp.*, 313 U. S. 215. The rationale of this case is the same as in the *Geist* case, i. e. "the theme of the Bankruptcy Act is equality of distribution" and that "To bring himself outside of that rule an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice" (313 U. S. at page 219).

[13] Similarly, Judge Frank, who wrote the opinion of the court below requiring subordination of the petitioner-held certificates, favored parity treatment in the *Geist* case. See his dissent in the *Geist* case in the circuit court of appeals, 122 F. 2d 503, 507–10.

not dispute the Chief Justice's position in the *Ferris* case. They merely found it unnecessary to discuss the *Geist* doctrine because they believed state rather than federal law to be properly applicable in the *Ferris* case.

Since the facts in the instant case, "for all practical purposes, are the same as those in the *Ferris* case" (R. 159), they present an equitable basis for subordination which this Court was unable to find in the *Geist* case but which the concurring Justices found to exist in the *Ferris* case.

However, petitioner contends (Pet. 12–15) that the equity rule which subordinates certificates held by the guarantor in order to prevent competition with the publicly-held guaranteed certificates, applies only to *solvent* sureties.[14] But solvency of the guarantor is a procedural consideration, i. e., in order to avoid circuity of action a solvent guarantor's certificates will be subordinated. There are other considerations of an equitable nature which the *Geist* case recognized

[14] Petitioner attempts also to distinguish between a guarantor in the position of Prudence, which makes its profit by making mortgage loans and selling certificates of participation in the mortgage, and a surety company which receives a premium for guaranteeing undertakings (Pet. 19–24). However, the *Geist* case and the concurring opinion in the *Ferris* case made no such distinction and indicate that the suretyship rule enunciated in *United States* v. *National Surety Co.*, 254 U. S. 73; *Jenkins* v. *National Surety Co.*, 277 U. S. 258; and *American Surety Co.* v. *Westinghouse Electric Mfg. Co.*, 296 U. S. 133, is applicable in the instant case.

will warrant subordination though the guarantor be insolvent. The facts in the instant case show the acquisition of securities just prior to and after maturity at a time when the guarantor, if not actually insolvent, had at least a seriously impaired capital and was forced to borrow from the government to prevent immediate bankruptcy. Acquisitions under the circumstances set forth were clearly not "independent of the guaranty." Plainly, they were intended to reduce or postpone the guarantor's liability on the certificates. Petitioner argues that the aggregate discount in the repurchases of Tigo's certificates by Prudence was not very large (Pet. 14–15). While the discounts were somewhat larger in the *Ferris* case, we regard the variation as immaterial since the policy of Prudence was to take advantage of discounts where obtainable (see note 7, *supra*).

Prudence's fiduciary position with respect to the certificate holders emphasizes the inequity of permitting it to prove on a parity those certificates which it purchased from its beneficiaries at substantial discounts or by exchanging certificates of later maturity.[15] Nor are the equities in favor

[15] Prudence's activities in acquiring the certificates must be considered in the light of the provisions of the guaranty agreement under which the guarantor virtually assumed the functions of an indenture trustee for the certificate holders. Under the terms of the guaranty (R. 25–28) the guarantor "is made irrevocably the agent" of the certificate holders to collect the principal and interest as it falls due on "said bond and mortgage aforesaid" (R. 25). The guarantor is bound

of petitioner's holdings enhanced by the fact that some of the purchases at a discount were made through a concealed brokerage account. Had the guarantor shown greater respect for the integrity of its obligation and undertaken to make payments pro rata on account of its guaranty to the extent of available funds, no question could have arisen as to the guarantor's successor asserting any rights of subrogation against the individual real estate properties until after its guaranty had been discharged in full. Thus, unless subordination is enforced the remaining holders of the guaranteed obligations will have been prejudiced by the failure to make a pro rata payment which in turn involved an attempt of the guarantor to escape full responsibility on its obligations.

Accepting petitioner's argument would mean that all equities should be brushed aside in favor of parity of treatment because the guarantor is insolvent. This would not be following the *Geist* case but going far beyond its holdings. As stated by the court below, in holding that petitioner's certificates are not entitled to parity under the *Geist* doctrine (R. 158–9):

> * * * we take as our guide the concurring opinion of Chief Justice Stone in the *Ferris* case. Regarding the *Geist* doctrine

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to take "any action or proceedings which it may deem necessary to enforce" the bond and mortgage (R. 27) and is given the right "to enforce payment of any sums which may be or become due under said bond and mortgage" (R. 28).

as still possessed of full vitality, he held it inapplicable to the facts of the *Ferris* case because, on those facts, unlike those in the *Geist* case, parity treatment of the certificates held by the guarantor was inequitable, and subordination equitable. The facts here, for all practical purposes, are the same as those in the *Ferris* case. Following Chief Justice Stone's opinion, we therefore hold that subordination here was required.

2. Petitioner contends that the decree of the court below, in directing subordination pursuant to respondents' prayer for general relief in their motion to amend the confirmed plan, was not responsive to the motion and amended the plan without a hearing and without submission for acceptance in violation of Section 222 of Chapter X (11 U. S. C. sec. 622) (Pet. 16–19). This contention we believe to be without merit. The relief which the court below granted was closely related to the proposed amendment to reserve the question of parity for adjudication by a court of competent jurisdiction. This amendment, as petitioner admits (Pet. 7–8; see R. 111, 112), in effect sought subordination of the petitioner-held certificates, being based on the decision in the *Ferris* case in the New York Court of Appeals, 292 N. Y. 210. In our opinion Section 222 is not involved because the court below did not decide that a particular amendment should have been approved

by the district court, but merely decreed subordination pursuant to the prayer for general relief.[16] Subordination being required on equitable principles, further proceedings relative to the plan would have to take place in the district court pursuant to the mandate of the court below. At that time all questions of the necessity for a vote and the persons entitled to vote could be decided on a record made for that specific purpose.

Such a record would, for example, establish whether the subordinated certificates were entitled to participate and if so to what extent. At that time petitioner will, of course, be heard as to the extent of its participation. However, consideration of such questions at the present time, and on the present record, would be premature.

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[16] The court below did not consider whether the district court "abused its discretion in refusing to adopt those specific changes" (R. 157). The court said: "* * * as that motion contained a prayer for general relief, we think the question of the subordination of the certificates held by the guarantor is properly before us on the appeal from the order denying that motion." (R. 157.)

CONCLUSION

The decision of the court below is correct and in accord with the decisions of this Court. The petition should be denied.

Respectfully submitted.

ROGER S. FOSTER,
Solicitor,
Securities and Exchange Commission.

In view of the adverse interest of the R. F. C., this memorandum is filed by counsel for the Securities and Exchange Commission, with my authorization.

HAROLD JUDSON,
Acting Solicitor General.

AUGUST 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945